No. 18258

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

McCullough Tool Company,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S BRIEF.

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Opinion Below.

The findings of fact and the opinion of the Tax Court [R. 32-48] are reported at 33 T. C. 743.

Jurisdiction.

This petition for review [R. 52-54] involves excess profits taxes for the years 1951 and 1952. The notice of deficiency [R. 14-23] was mailed to the taxpayer on January 9, 1957. Within the prescribed ninety-day period, on April 8, 1957, the taxpayer filed a petition for redetermination with the Tax Court under the provisions of Section 6213 of the Internal Revenue Code of 1954 [R. 1-13]. The decision of the Tax Court [R. 51] which in part sustained the Commissioner's deficiency determination was entered on April 12, 1962.

The taxpayer maintains its principal office in the County of Los Angeles, State of California and filed its income tax returns for the years in question in the office of the Collector of Internal Revenue (or District Director of Internal Revenue) at Los Angeles, California. The case comes to this Court upon petition for review filed July 9, 1962 [R. 52-54]. Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

Questions Presented.

The ultimate question presented by this appeal is whether the taxpayer, the petitioner herein, was entitled to include in its "borrowed capital" in computing its excess profits tax credit its indebtedness to certain individuals which was evidenced by certain so-called Modification Agreements dated December 28, 1950.

The subsidiary and specific question presented is whether or not the indebtedness of the taxpayer was evidenced by one of the types of evidence of indebtedness required by Section 439 of the Internal Revenue Code of 1939.[1]

The questions presented arise from the Tax Court's application of that portion of Section 439(b)(1) which requires that an indebtedness to be included in "borrowed capital" must be evidenced by at least one of certain types of evidence of indebtedness, including *inter alia* a note and a conditional sales contract. The Tax Court decided that the written instruments here in question were neither notes nor conditional sales contracts.

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[1]All section references herein are to the Internal Revenue Code of 1939 unless otherwise noted.

Such decision presents the following questions of law:

(1) What is the meaning of the word "note" as that term is used in Section 439(b)(1)?

(2) Is a written contract which contains all of the essential elements of a note a "note" within the meaning of Section 439(b)(1) notwithstanding the fact that it contains other collateral agreements?

Statement of Case.

The facts in the case below were to a large part stipulated, and such facts are as set forth in the Stipulation of Facts [R. 26-28] and documentary exhibits referred to therein. Before the Tax Court below two issues were presented for decision. Both of those issues were governed by the nature and effectiveness of certain so-called Modification Agreements dated December 28, 1950. The first issue presented was whether or not the Modification Agreements created in the petitioner a fixed cost for certain patents so that thereafter the petitioner was entitled to deduct depreciation under Section 23(1)(1) instead of royalties under Section 23(a)(1)-(A). The Court below found that a fixed cost for the patents was created by the Modification Agreements and that the petitioner was entitled to deduct depreciation rather than royalty expense. That portion of the Tax Court's decision is not involved in this appeal. The second issue presented below was whether or not the Modification Agreements created an indebtedness of the petitioner which it could include in its "borrowed capital" for excess profits tax purposes in accordance with Section 439(b)(1). The Court below held that such indebtedness could not be so included and it is that portion of the Tax Court's decision which is the subject of this appeal.

Except for certain omissions which petitioner deems important, the Tax Court's statement of the primary facts is accurate and will be adopted as the petitioner's statement of facts. Petitioner's additions to the Tax Court's statement of facts will be indicated as follows: "(Par. added by petitioner)"

The petitioner is a corporation organized under the laws of the State of Nevada, with its principal place of business at Los Angeles, California. It filed its corporation income tax return for the year 1951 with the collector of internal revenue, Los Angeles, and its return for 1952 with the director of internal revenue, Los Angeles [R. 33-34].

At all times pertinent herein 80 per cent of the stock of petitioner was owned by I. J. McCullough and 20 per cent was owned by his brother, O. J. McCullough. I. J. McCullough and O. J. McCullough are sometimes hereinafter referred to as the McCulloughs [R. 34].

Since its inception in 1941 petitioner has been and is now engaged in the rendition of perforating and other highly specialized services to the oil drilling industry. The business in which petitioner is engaged is highly competitive and approximately 75 per cent of such business is founded on a number of patents which it either owns or is licensed to use [R. 34].

Prior to January 1, 1944, the McCulloughs were the owners of certain patents (hereinafter referred to as the bullet patents) governing the manufacture, use, and sale of bullet-like projectiles for the perforation of oil wells [R. 34].

On January 1, 1944, petitioner and the McCulloughs entered into an agreement whereby petitioner received an exclusive license to make, use, and sell devices manufactured in accordance with the bullet patents. The agreement provided, *inter alia*:

1.

> The Licensors hereby grant to the Licensee, upon and subject to the conditions, covenants, restrictions and terms hereinafter contained, the full and exclusive right and license during the continuance of this agreement to make, use and sell throughout the United States, its territories and possessions, devices made in accordance or disclosed in the aforesaid patents set forth on Exhibit A for the full term of said patents and until the expiration date of the last of said patents.

2.

> It is mutually understood and agreed that the license granted in Paragraph 1 hereof is granted subject to the condition that it does not and shall not empower the Licensee, directly or indirectly, to license any other person or persons, natural or artificial, to use said patents.

* * * * *

4.

> The Licensee further agrees to keep books, records and accounts of all work performed during the life of this agreement of all work done hereunder, and all such records or accounts shall at and during the usual business hours be open to the inspection of the Licensors or their duly authorized representative.

5.

On or before the 15th day of each calendar month after the execution hereof and during the continuance of this agreement, the Licensee shall mail a statement to each of the Licensors containing the information required in Paragraph 4, hereof, showing all charges for use and sales by the Licensee under this agreement during the next preceeding [sic] calendar month.

6.

In consideration of the rights and licenses herein given and granted by the Licensors to the Licensee, the Licensee agrees to pay to the Licensors at the time of rendering the statement required by Paragraph 5 hereof, a royalty consisting of a sum equal to twelve and one-half per cent (12½%) of the total gross price charged by the Licensee for all gun perforating done and all sales of parts and equipment in accordance with the herein license and patents, and one-fourth (¼) of the said royalty shall be paid to the Licensor O. J. McCULLOUGH and three-fourths (¾) of the said royalty shall be paid to the Licensor I. J. McCULLOUGH.

7.

The Licensee shall have the right to terminate this agreement upon first giving ninety day notice in writing to the Licensors to cancel and terminate this agreement together with all rights, licenses and obligations hereunder, provided, however, that no such termination or cancellation shall relieve the Licensee from the payment of any royalty due and payable to the Licensors at the time of such termination.

8.

In the event that either party shall violate any covenants of this agreement, the aggrieved party may give to the defaulting party written notice of such breach accompanied by sufficient particulars to reasonably enable the defaulting party to determine the alleged nature and extent of the breach, and if the defaulting party shall fail for a period of thirty days after the service of such notice to remedy such breach, the aggrieved party may, at its option, terminate and cancel this agreement and all of the rights and licenses of any defaulting party hereunder. The waiver of any particular breach or breaches by the aggrieved party shall not be deemed to constitute a waiver of any continuing breach or of any future breach by the defaulting party of this agreement [R. 34, 35, 36].

On October 1, 1957, petitioner entered into an exclusive license agreement with Earl J. Robishaw and William G. Sweetman regarding several patent applications (hereinafter referred to as the jet patents) governing the manufacture, use, and sale of shaped charges of explosives for the perforation of oil wells, devices sometimes known as jet perforators. The process of jet perforation of oil wells covered by the jet patents was not sufficiently developed at the time of the agreement to be commercially usable. Petitioner under the agreement undertook the responsibility and expense of further development of the jet patents. In all other material respects the agreement was similar to the agreement for the bullet patents except as to the amount of royalty, the length of periods for notice of termination, and the transferability of the license. The agreement makes no mention of the right to grant sublicenses [R. 36, 37].

Neither Robishaw nor Sweetman was an employee of petitioner on October 1, 1947 [R. 37].

In July 1948, each of the McCulloughs acquired a 25 per cent interest in the jet patents. At that time the jet patents were still not commercially usable [R. 37].

On December 28, 1950, the McCulloughs and petitioner executed a document entitled "Modification Agreement" which provided:

> WHEREAS, the parties hereto on the first day of January, 1944 did make and enter into an Agreement by which the [McCulloughs] sold to the [petitioner] certain patents and patent applications listed on Exhibit "A" attached thereto; and
>
> WHEREAS, said Agreement was termed a "License Agreement" and the parties thereto were referred to as Licensors and Licensee, respectively, although the Agreement was intended to be, and, in law, was actually an agreement of sale; and
>
> WHEREAS, Paragraph 6 of said Agreement provided for payments to the [McCulloughs], which payments were termed "royalty", of 12½% of the total gross price received by the [petitioner] for services and sales under the said patents and patent applications; and
>
> WHEREAS, the parties are desirous of modifying said provision for payment and substituting therefor a fixed and determinable total remaining price to be paid by the [petitioner] in consideration for the sale of the said patents;

NOW, THEREFORE, in consideration of the mutual promises of the parties hereto, IT IS AGREED AS FOLLOWS:

1. Paragraph 6 of said Agreement of January 1, 1944 is modified to read as follows:

"6.

"In consideration of the rights in and to the patents and patent applications transferred, assigned and sold by the [McCulloughs] to the [petitioner], the [petitioner] hereby agrees to pay to the [McCulloughs], in addition to all other payments heretofore made hereunder, $20,000.00 per month on the 28th day of each calendar month, commencing on the 28th day of December, 1950, for a period of six years and one month. The last of said monthly payments shall be due and payable on the 28th day of December, 1956. One-fourth of each of said monthly payments, or $5,000.00, shall be paid to O. J. McCULLOUGH, and three-fourths of said monthly payments, or $15,000.00, shall be paid to I. J. McCULLOUGH. The parties are agreed that the total of these payments, $1,460,000.00, shall be the full remaining price to be paid by the [petitioner] for the complete and absolute ownership of the patents and patent applications described in Exhibit 'A'."

2. It is agreed by the parties hereto that any and all provisions of said Agreement of January 1, 1944 which are inconsistent with this Modification Agreement shall have no effect. Said Agreement of January 1, 1944 has been considered by the par-

ties thereto as an absolute assignment or sale of the subject matter thereof. That Agreement together with this Modification thereof shall be similarly construed hereafter [R. 37, 38].

On December 28, 1950, the parties to the jet patent agreement or their assignees entered into similar modification agreements, effect of which, *inter alia,* was to substitute the total price of $2,870,000 for the payment of a royalty. In all other respects the agreements were almost identical to the modification agreement relating to bullet patents [R. 38].

Petitioner made all payments for the bullet patents due the McCulloughs under the modification agreement. Petitioner's gross sales of parts and services under the bullet patents, the royalty payable thereon which would have been paid under the agreement of January 1, 1944, the actual payments made under the modification agreement, and the excess of what royalty payments would have been paid under the agreement of January 1, 1944, over actual payments for the years 1950 to 1958 are as follows:

Year	Sales	Royalty	Actual Payments	Excess
1950 (Dec. only)	—	—	$ 20,000.00	$ (20,000.00)
1951	$ 2,073,301.88	$ 259,162.74	240,000.00	19,162.74
1952	2,311,565.79	288,945.72	240,000.00	48,945.72
1953	2,908,134.84	363,516.86	240,000.00	123,516.86
1954	3,140,828.54	392,603.57	240,000.00	152,603.57
1955	3,268,037.83	408,504.73	240,000.00	168,504.73
1956	3,948,232.27	493,529.03	240,000.00	253,529.03
1957	2,688,173.28	336,021.66	—	336,021.66
1958	2,250,591.30	281,323.91	—	281,323.91
	$22,588,865.73	$2,823,608.22	$1,460,000.00	$1,363,608.22

* Under the Modification Agreement of December 28, 1950, the fixe payment terminated December 1956. Under the prior Licens Agreement of January 1, 1944, the royalty payments would hav continued until approximately 1968 [R. 39].

Petitioner has made all payments for the jet patents due to the owners or assignees under the modification agreement. Petitioner has made no attempt to terminate the agreement and in 1952 made advances to one of the parties of payments due for the 5 years next ensuing. Petitioner's gross sales of parts and services under the jet patents, the royalty payable thereon if such royalty payments had been made under the agreement of October 1, 1947, the actual payments made under the modification agreement, and the excess of what royalty payments would have been made under the contract of October 1, 1947, over actual payments for the years 1950 to 1958 are as follows:

Year	Sales	Royalty	Actual Payments	Excess
1950 (Dec. only)	—	—	$ 14,000.00	$ (14,000.00)
1951	$ 2,391,904.25	$ 239,190.43	168,000.00	71,190.43
1952	2,953,871.53	295,387.15	168,000.00	127,387.15
1953	3,323,230.48	332,323.05	168,000.00	164,323.05
1954	3,478,612.41	347,861.24	168,000.00	179,861.24
1955	4,012,038.67	401,203.87	168,000.00	233,203.87
1956	4,490,768.51	449,076.85	168,000.00	281,076.85
1957	3,799,971.39	379,997.14	168,000.00	211,997.14
1958	3,569,073.75	356,907.38	168,000.00	188,907.38
	$28,019,470.99	$2,801,947.11	$1,358,000.00	$1,443,947.11

[R. 39, 40]

Petitioner incurred its obligations under the modification agreements of 1950 in good faith and for the purposes of its business [R. 40].

On its books of account the petitioner reflected the Modification Agreements of December 28, 1950 by debiting to its asset account called "Patents (Capital Asset)" the two amounts of $1,460,000.00 and $2,870,000.-

00 and crediting an account called "Liability for Pur-chase of Patents" with identical amounts [R. 28, Ex. L. M.] (Par. added by petitioner).

The average daily amount of petitioner's obligations under the Modification Agreements of December 28 1950 was $4,104,109.58 in 1951 and $3,693,250.55 in 1952 [Exs. M, N and O] (Par. added by petitioner).

Specification of Errors.

1. The Tax Court erred in sustaining respondent's de-termination that the so-called Modification Agree-ments dated December 28, 1950 did not create an out-standing indebtedness which could be included in peti-tioner's borrowed capital for the purpose of comput-ing its excess profits tax credit for the taxable years 1951 and 1952, and in sustaining deficiencies in peti-tioner's income taxes for such years based upon such determination.

2. The Tax Court erred in concluding and deciding that the Modification Agreements of December 28, 1950 were not "notes" within the meaning of Section 439 (b)(1).

3. The Tax Court erred in failing to find that the Modification Agreements, together with the License Agreements to which they relate, do contain uncondi-tional written promises to pay sums certain in money at fixed or determinable future times.

Summary of Argument.

I.

To qualify for inclusion in "borrowed capital" for excess profits tax purposes Section 439(b)(1) requires a corporate obligation to be an "outstanding indebtedness" incurred in good faith for the purposes of the business and that it be evidenced by one of several designated types of evidence of indebtedness, including *inter alia* a "note."

II.

An "outstanding indebtedness" has been held to be an unconditional obligation to pay. The Modification Agreements of December 28, 1950 create such an obligation in the petitioner. The Tax Court found as a fact that the petitioner's indebtedness was incurred in good faith and for the purposes of its business [R. 40].

III.

The Modification Agreements constituted "notes" as that term is used and understood both in general law and in Section 439(b)(1).

IV.

The Tax Court erred in its reliance on *Journal Publishing Co. v. Commissioner* (1944), 3 T. C. 518, and in failing to find that the Modification Agreements were notes within the meaning of Section 439(b)(1).

ARGUMENT.

I.

General Statement of Requirements Regarding Inclusion of Indebtedness in Borrowed Capital for Excess Profits Tax Purposes.

Section 439 of the 1939 Internal Revenue Code sets forth what may be included in "borrowed capital" for the purpose of computing a taxpayer's excess profits tax credit. Subsection (b) of that section defines daily borrowed capital and it in turn contains four subparagraphs which set forth what may be included in daily borrowed capital. Subparagraphs (2), (3) and (4) are not pertinent to the issues involved herein. Subparagraph 1, however, provides as follows:

> "The amount of the outstanding indebtedness (not including interest) of the taxpayer incurred in good faith for the purposes of the business which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement or conditional sales contract . . ."

In essence then, Section 439(b)(1) sets forth three basic requirements which must be met before an indebtedness of a taxpayer may be included in its borrowed capital for excess profits tax purposes. These requirements are (1) that the indebtedness be a "outstanding indebtedness", (2) that such indebtedness shall have been incurred in good faith and for the purposes of the business and (3) that such indebtedness shall have been evidenced by one of the indicated types of evidence of indebtedness.

In the instant case, the Tax Court has found as a fact that the indebtedness of the petitioner was incurred in good faith and for the purposes of its business [R. 40].

II.

The Modification Agreements Created an "Outstanding Indebtedness" as That Term Is Used in Section 439(b)(1) of the Internal Revenue Code.

It has been established that to qualify as an "outstanding indebtedness" within the statute, the indebtedness of the taxpayer must be unconditional and the amount payable must be certain. In *C. L. Downey Company v. Commissioner of Internal Revenue,* C. A. 8 (1949), 172 F. 2d 810, the Court in determining whether or not the taxpayer had an outstanding indebtedness, as that term was used in Section 719(a)-(1), the World War II Excess Profits Tax Law counterpart to Section 439(b)(1), quoted with approval from the language of the Court in *Gilman v. Commissioner,* C. A. 8 (1931), 53 F. 2d 47. That Court said: "The term indebtedness as used in the Revenue Act implies an unconditional obligation to pay," and further "while the sum of money may be payable upon a contingency yet in such case it becomes a debt only when the contingency has happened, the term debt being opposed to liability when used in the sense of an inchoate or contingent debt." Also see *Canister Co. v. Commissioner,* C. A. 3 (1948), 164 F. 2d 579, wherein it was held that an obligation under a surety bond was contingent only and therefore did not constitute an outstanding indebtedness.

The indebtedness of the petitioner in the instant case is absolutely unconditional. Each of the Modification Agreements of December 28, 1950 [Exs. E, F, G, H, I, and J] unequivocably states that the corporation (petitioner) agrees to pay to the particular individual named therein the particular amounts of money specified therein and at the times specified therein. The Modification Agreements, by their very terms, contemplate an absolute sale of the subject patents by the several individuals involved to the petitioner. This absolute sale is to be distinguished from a fictional sale which takes place pursuant to an exclusive license of all of the rights in a patent. See *Edward C. Myers* (1946), 6 T. C. 258. In the case of a sale where the buyer promises to pay in the future, the antecedent obligation of the seller for which the buyer's promise to pay is given becomes merged and no further duty is required of the seller-promisee. See *Williston on Contracts* (1936 Edition), Section 221.

The Modification Agreements were found by the Tax Court to be valid and enforceable contracts [R. 42-43] and further that the payments made under the Modification Agreements are directly attributable to the *purchase of the patents* [R. 43]. (Emphasis supplied). The owner of a patent owns all of the rights in such patent while the licensee of a patent, regardless of the fact that the license is exclusive and covers the right tc make, use and vend and regardless of the fact that such an exclusive license has been held to be a sale for tax purposes, *Edward C. Myers, supra,* possesses only such rights as are granted to him in the license agreement, and is also subject to the obligations imposed upon him thereby. Conversely, the licensor of a patent retains numerous rights in the patent and in the license agreement while the seller of a patent retains no rights in the patent and once having received full payment therefor has no further rights at all. The agreements specifically provide that any and all provisions of the prior License Agreements having reference to the same patents which are inconsistent with the terms of the Modification Agreements shall have no further force or effect [R. 38]. Therefore, any and all provisions of the prior License Agreement which are inconsistent with an absolute sale of the patents by the individuals to the petitioner are completely nullified. Clearly included among such nullified provisions is that which gives the petitioner any rights of termination [R. 36].

It is, therefore, the contention of the petitioner that its obligations created and evidenced by the Modification Agreements of December 28, 1950 are unconditional and payable in all events and that as such they constitute an "outstanding indebtedness."

In further support of its contention, the petitioner points to the fact that it has consistently treated these obligations as being fixed and unconditional. After entering into these Modification Agreements of 1950, the petitioner made entries on its books of account which reflected its ownership of the patents and the liability for the purchase thereof. Exhibit L herein [R. 28], which is a transcript of the petitioner's journal, indicates an entry of December, 1950 in which the petitioner debits an asset account entitled "Patents" with the amount of $1,460,000.00 and credits an account entitled "Liability for Purchase of Patents" with an equal amount. The statement accompanying such entry in the journal is as follows: "To record liability for purchase of Bullet perforator patents under Agreements of December 28, 1950." Petitioner's Journal [Ex. L herein] also indicates an entry in which an asset account entitled "Patents" is debited with the amount of $2,870,-000.00 and a liability account entitled "Liability for Purchase of Patents" is credited with a like amount. This entry is accompanied by the explanatory statement: "To record liability for purchase of Jet patents under Agreements of December 28, 1950."

Exhibit M herein [R. 28], which is a photostatic transcript of the petitioner's account No. 68 entitled "Liability for Purchase of Patents" reflects the credits of $1,460,000 and $2,870,000 referred to above and further reflects the monthly payments to the individuals entitled thereto of $20,000 in so far as the Bullet patents are concerned and $14,000 in so far as the Jet patents are concerned.

As an additional indication of its treatment of the obligations created by the Modification Agreements as fixed and unconditional obligations, the petitioner on October 20, 1952, made an advance payment in the amount of $19,950 to James M. Gray, one of the individuals entitled to payments under the Modification Agreements relating to the Jet patents [R. 39]. See Petitioner's Exhibit 5 herein [Tr. 41-44], which is a copy of a letter addressed to James M. Gray signed by Mr. A. D. Beeman, Secretary-Treasurer of the petitioner. In such letter Mr. Beeman states as follows: "Per terms of that certain modification agreement dated December 28, 1950, McCullough Tool Company agreed to pay you $71,750 at the rate of $350 per month beginning December 28, 1950, and as of September 28, 1952 has paid $7,700 leaving a balance as of this date of $64,050." Such letter then goes on to make reference to Mr. Gray's verbal application for an advance payment and the remittance thereof to him [Tr. 43-44].

The petitioner, therefore, contends that the clear and unambiguous language of the Modification Agreements and its consistent treatment of such agreements thereafter make it absolutely clear that a fixed and unconditional obligation was created by the Modification Agreements of 1950, and that such obligations constituted a "outstanding indebtedness" of the petitioner.

In further support of this contention the petitioner calls the Court's attention to the fact that the Tax Court in the instant case decided that the Modification Agreements established in the petitioner a fixed cost for the several patents involved and that the petitioner was, after December 28, 1950, entitled to compute and deduct depreciation or amortization of such fixed cost of the patents under Section 23(1)(1) of the Code rather than to deduct royalty expense under Section 23-(a)(1) of the Code [R. 41-43]. It is respectfully submitted by the petitioner that had the Tax Court felt that the Modification Agreements had not established a fixed and unconditional obligation on the part of the petitioner, it would not have determined that the Modification Agreements had created a fixed cost for depreciation purposes.

III.

As a Matter of General Law a Written Instrument Which Contains the Essential Elements of a Note Is a Note.

A "note" is "a written promise to pay a certain sum of money at a future time unconditionally". This definition of a note is found in both Black's Law Dictionary (1933 Edition) and Bouvier's Law Dictionary (1914 Edition). Section 184 of the Uniform Negotiable Instruments Act defines a negotiable promissory note as "an unconditional promise in writing made by one person to another signed by the maker engaging to pay on demand or at a fixed or determinable future time a sum certain in money to order or to bearer . . ." 5 *Uniform Laws Annotated.* Said definition is also found in Section 3265 of the Civil Code of the State of California. These definitions of a note were accepted and approved by the Tax Court in *Journal Publishing Co.* (1944), 3 T. C. 518, 523 and 524. The latter definition found in the Uniform Negotiable Instruments Act, of course, contains the element of negotiability. Such element is not required in a note, however, in order for the indebtedness evidenced by such note to be includible in a taxpayer's borrowed capital. See *Oregon-Washington Plywood Co. v. Commissioner of Internal Revenue,* C. A. 9 (1955), 219 F. 2d 883. Therefore, if the words which create negotiability are eliminated from the definition found in the Uniform Negotiable Instruments Act, such definition is essentially identical to that found in Black's and Bouvier's Law Dictionaries. Ballentine's Law Dictionary (1948 Edition) defines a note as "a written promise to pay another a certain sum of money at a certain time." None of such definitions require the use of any particular words (except in so far as negotiability is concerned), nor do they require any particular form. Neither do they prohibit a note from containing other provisions. It is therefore submitted that any written instrument which contains the essential elements of a note, as such are set forth in the above definitions, is a note regardless of its form and regardless of the fact that it may contain other provisions, so long as such other provisions do not impair or affect the required characteristics of a note. The Supreme Court of the State of California in an early decision stated as follows with reference to a promissory note: "No particular form of words is necessary to constitute such a writing. The form of it may be varied at the pleasure of the individual executing it, provided that in all cases the form adopted amounts, in legal effect, to a written promise for the payment of money, absolutely and at all events, and it interferes with no statute regulation." *Strickland v. Holbrooke* (1888), 75 Cal. 268, 17 Pac. 204, 205. In *Commissioner of Internal Revenue v. Meridian and Thirteenth Realty Co.*, C. A. 7 (1942), 132 F. 2d 182, the Court with approval quotes from Paul and Merten's "Law of Federal Income Taxation" as follows: "The characteristics of a note are a definite obligor, a definite obligee (either by name or designation), a definitely ascertainable obligation, and a time of maturity, either definite or that will become definite." In *United States v. Ely and Walker Dry Goods Co.*, C. A. 8 (1953), 201 F. 2d 584, the Court in considering certain documents finds them to be promissory notes in spite of the fact that they contain provisions far in excess of the bare essentials of a note.

IV.

A Written Instrument Which Contains the Essential Elements of a Note Is a Note Within the Meaning of Section 439(b)(1) of the Internal Revenue Code.

Section 719 of the so-called World War II Excess Profits Tax Law, which is essentially the counterpart of Section 439 governing the instant case, included a "note" as one of the types of evidence of indebtedness which would permit a taxpayer to include such indebtedness in its borrowed capital. The respondent, in his regulations interpreting Section 719, interpreted the word "note" as "promissory note." Reg. 112, Section 35.719-1. The respondent similarly interprets such word in his regulations issued under Section 439, Reg. 130, Section 40.439-1. It is submitted, however, that there is no distinction between the two terms. The word "note" by its very definition is promissory. From a definitive standpoint the adjective promissory in front of the word note adds nothing. Also see *Quinn v. Mathiassen* (1935), 4 Cal. 2d 329, 49 P. 2d 284, wherein the Court held that the use of the word "note" in a complaint requiring the allegation of a "promissory note" was sufficient.

The petitioner has found no cases interpreting the word "note" under Section 439 of the Internal Revenue Code. It is believed, however, that such word should receive the same interpretation as it has received under the respondent's prior regulations and under cases decided under the prior Excess Profits Tax Law. As stated above, the Tax Court has in *Journal Publishing Co., supra,* accepted and approved the definitions stated above from Black's and Bouvier's Law Dictionaries and from the Uniform Negotiable Instruments Law in a case involving Section 719(a)(1) of the prior Excess Profits Tax Law.

Additionally, it has been established that whether or not a document shall be considered as one of the permitted types of instruments under Section 719 of the prior Excess Profits Tax Law is a matter for controlling determination by the Federal Courts but pertinent State decisions shall be deemed a reasonable source of guidance. *Brewster Shirt Corporation v. Commissioner,* C. A. 2 (1947), 159 F. 2d 227. It has been further established that whether or not one of the permitted types of evidence of indebtedness exists is a question of substance and not of form. *Brewster Shirt Corporation v. Commissioner, supra.*

In *Oregon-Washington Plywood Co. v. Commissioner, supra,* this Court, in addition to holding that a note need not be negotiable for the purposes of Section 719(a)(1) of the prior Excess Profits Tax Law, held that a document purporting to be a note must be read in conjunction with the contract to which it refers in determining whether the essential characteristics of a note are present. In that case the so-called note read as follows:

> "Tacoma, Washington, September 30, 1943.
>
> $400,000.00
>
> "As provided in an agreement dated August 30, 1943, the undersigned for value received, promises to pay to the order of the Peterman Manufacturing Company the sum of Four Hundred Thousand Dollars ($400,000.00) in lawful money of the United States of America. Payments on this note

plus accrued interest at the rate of 3% per annum on deferred balances shall be made on the 15th day of each month beginning November 15, 1943.

"The basis of such principal payments to be $5.00 per thousand feet commercial log scale for all logs except wood logs cut and removed by purchaser or its agents during the previous calendar month as provided in the agreement between T. A. Pterman and Ida C. Pterman, owners, and Oregon-Washington Plywood Company, purchaser, dated August 30, 1943, covering certain timber lands in Tillamook County, Oregon.

"Oregon-Washington Plywood Company.
By /s/ Philip Garland, Vice President.
Attest: /s/ Mathilda M. Barett.
Secretary."

219 F. 2d 883, 885.

The contract of August 30, 1943 referred to in said note was supplemented by an agreement between the same parties dated September 18, 1943. The Commissioner in that case apparently contended that the "note" did not definitely fix the time or amount of the monthly payments.

This Court affirms the essential correctness of the Tax Court's definition of a note as found in *Journal Publishing Co., supra,* citing in support thereof *Consolidated Goldacres Co. v. Commissioner,* C. A. 10 (1948), 165 F. 2d 542; *Flint Nortown Theatre Co. v. Commissioner* (1945), 4 T. C. 536; and *Bernard Realty Co. v. United States,* C. A. 7 (1951), 188 F. 2d 861, and then holds that the so-called note, the agreement of August 30, 1943 and that of September 18, 1943 when read as a whole supply all of the essential provisions of a note. In so holding this Court states as follows:

> "The provisions of the August 30, 1943 contract and the note, as a whole, clearly express the intention and agreement of the parties that reasonably prompt and substantial logging be accomplished and that payments based on the monthly amount of logging be commenced within a reasonable time." 219 F. 2d 883, 887-888,

and further:

> "Respondent contends and the Tax Court held that the August 30, 1943 contract must be read into the note, at least to the extent of determining monthly payments. By the same token, the September 18, 1943 contract between the same parties must be read into or with the prior contract and the subsequent note. That contract required logging to commence on the timberland in October, 1943 with a specified minimum by February, 1944 and continuing until the entire tract was logged." 219 F. 2d 883, 888.

This Court then finds that any deficiency regarding the time for payment which might exist in the so-called note standing alone is supplied by the terms of the two agreements. See also *Merten's, Law of Federal Income Taxation,* Vol. 7A, Section 42.186, footnote 78, in which the authors in commenting on *Adams Bros. Co. v. Commissioner,* 22 T. C. 395, rev'd 222 F. 2d 501, C. A. 8 (1955), state as follows:

> "The Circuit Court emphasized the fact of a genuine underlying indebtedness which became part of the taxpayer's operating capital. In such event there may be a tendency on the part of the ap-

pellate courts not to permit technicality to frustrate a benefit within the contemplation of the statute. See also the appellate decision in the *Oregon-Washington* case, note 76, *supra*."

It is respectfully submitted that the holding of this Court in the *Oregon-Washington Plywood Co.* case is ample authority for a decision that the Modification Agreements involved herein are "notes."

The petitioner contends that when the definitions and decisional guideposts set forth above are applied to the Modification Agreements of December 28, 1950, such agreements constitute notes as that term is used in Section 439(b)(1) of the Internal Revenue Code. Such Modification Agreements evidence an unconditional promise on the part of the petitioner to pay to those certain individuals named therein fixed and certain sums of money at fixed future dates. The petitioner's obligation to pay such amounts is absolutely unilateral and unconditional. The Modification Agreements must, of course, be read in conjunction with the prior agreement of January 1, 1944 and October 1, 1947, which they modify, but even then the petitioner's obligation is unilateral and unconditional because the Modification Agreements specifically provide that any provisions of such prior agreements which are inconsistent with the Modification Agreements shall have no effect. The Modification Agreements provide for an absolute sale of the subject patents by the several individuals involved to the petitioner. Such agreements at one time provided for and effected the sale of the patents to the petitioner and the antecedent obligations of the several individuals involved merged and thereafter the obligation of the petitioner was unilateral and unconditional. *Williston on Contracts, supra.*

V.

The Tax Court Erred in Failing to Find That the Modification Agreements Were Notes Within the Meaning of Section 439(b)(1).

The Tax Court in deciding as it did erred in relying to any extent upon *Journal Publishing Co. v. Commissioner of Internal Revenue, supra.* This case is clearly distinguishable from the instant case. In *Journal Publishing Co., supra,* the taxpayer had obligated itself by a written instrument to make periodic payments of certain sums to one of its competitors in connection with a transaction wherein the taxpayer purchased the competitor's assets including circulation galleys, circulation lists and records, statements of account, records relating to the sale, distribution and delivery of the competitor's newspaper, and rights to publish syndicated features. As a part of the transaction the competitor agreed not to resume the publication of a newspaper within a forty-mile radius of Portland, Oregon until after October 1, 1950, and to otherwise refrain from competing with the taxpayer during the period beginning August 22, 1939 and ending October 1, 1950. The payments to be made by the taxpayer to its competitor, both with regard to the purchase of the assets and the covenant not to compete, were to be made over a period which was co-terminous with the period of the covenant not to compete.

The pertinent question presented by *Journal Publishing Co., supra,* was whether or not the written instrument was a note within the meaning of Section 719(a)(1) of the Internal Revenue Code of 1939, which as stated above was the World War II Excess Profits Tax Law counterpart of Section 439(b)(1) which governs the instant case. The Court in *Journal Publishing Co., supra,* in examining the written instrument involved in that case cites the generally accepted definitions of a note found in Black's Law Dictionary (1933 Edition), Bouvier's Law Dictionary (1914 Edition), and in the Uniform Negotiable Instruments Act, *supra.* The Court then finds that that written instrument does not fit the definition of a note since the obligation of the taxpayer under that written instrument was not unconditional. The Court there found in effect that if the seller had defaulted in its covenant not to compete by somehow engaging in competition with the taxpayer in the restricted area and during the restricted period, the taxpayer's obligation to make payments under the contract would have been terminated. The Court found in effect that the obligation of the taxpayer under the written instrument was not unilateral, and that since a unilateral and unconditional obligation is one of the attributes of a note, the written instrument involved in *Journal Publishing Co., supra,* could not be a note.

The Tax Court in the instant case does not examine the Modification Agreements to determine whether or not the necessary qualifications of a note exist. The Tax Court in the instant case cites the following language from *Journal Publishing Co., supra:*

> "If the contract in the instant case were to be construed as a promissory note, its fair market value would be includible in the gross income of the News Co. in that year in which the contract was made. However, this Court has held that 'when evidence was introduced showing that the deferred payments were evidenced only by contract, where

no notes, bonds or other evidence of indebtedness other than the contract were given, such contract had no fair market value and that the amount of the deferred payments should be included in income when received.' Citing *C. W. Titus, Inc.,* 33 B. T. A. 928, 935. The authorities cited by petitioner do not go beyond confirming the essential correctness of the definitions of a promissory note as stated above. We are of the opinion that the contract *in the instant case* is not a 'note' within the meaning of §719 (a) (1) of the Internal Revenue Code, as amended by the Second Revenue Act of 1940." (Emphasis added) 3 T. C. 524.

After quoting this portion of the opinion from *Journal Publishing Co., supra,* the Court in the instant case merely goes on to say that the obligations of the petitioner in the instant case are not evidenced by notes. If the Tax Court in making its decision in the instant case placed its reliance on the above quoted portion of the opinion in *Journal Publishing Co., supra,* then its reliance is misplaced and merely begs the question. Such a holding in effect would be that a contract cannot be a note. This cannot be a true statement of law since every note is a contract. See *Williston on Contracts,* §1135 (Revised Edition). The Tax Court in the instant case completely fails to state wherein the Modification Agreements in question do not meet the requirement of notes, as such requirements are set out in the definitions of a note contained in Black's Law Dictionary, Bouvier's Law Dictionary and the Uniform Negotiable Instruments Act, *supra,* which the Tax Court in *Journal Publishing Co., supra,* conceded were correct definitions of a note.

On the other hand, the Tax Court in *Journal Publishing Co., supra,* took great pains to point out wherein the contract there involved failed to qualify as a note. The Court at two different points in its opinion points out that the obligation of the taxpayer in *Journal Publishing Co.* was not unconditional and unilateral. At one point the Court states as follows:

> "The promise to pay contained therein is not unconditional. It is an element in a bilateral contract and payment of the sums specified therein are in effect conditioned on the performance by the News Co. of certain promises, namely, to deliver assets and to refrain from publishing or otherwise competing with petitioner over a period of years extending to and including 1950." *Journal Publishing Co., supra,* at page 524.

Again, the Court in distinguishing *Aetna Oil Company v. Glenn* (1944), 53 Fed. Supp. 961, states:

> "The promise to pay there (in Aetna Oil Co.) involved was unilateral and absolute and with 'nothing further to be done by the payee in order to make the obligation a binding one' whereas here (*Journal Publishing Co.*) the contract was bilateral and the payee had a continuing obligation not to compete." *Journal Publishing Co., supra,* at page 524.

Indeed, contrary to the apparent holding of the Tax Court in the instant case, the Tax Court in *Journal Publishing Co.* impliedly held that a written contract could be a "note" if it contained the essential elements of a note, and the mere fact that it contained other provisions was immaterial so long as such other provisions did not destroy or affect the essential elements required of a document to be a note.

The latter statement was the specific holding of the Court in *Aetna Oil Co. v. Glenn, supra,* a case in which a situation very analogous to that presented in the instant case exists. The case involved a dividends paid credit as was provided for in Section 13(c) of the Revenue Act of 1938, as amended by the Revenue Act of 1939. Section 27 of such Act makes reference to an indebtedness and states that the indebtedness referred to includes only those which are evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust. The plaintiff in that case (Aetna Oil Co.) contended that a certain written contract under which it was indebted to another party was in fact a note within the meaning of such Act. The contract in question was entered into by Aetna Oil Co. and Gasoline Products Company, Inc. It granted to Aetna Oil Co. the right to use certain cracking patents in refining gasoline and provided that Aetna Oil Co. would pay to Gasoline Products Company three-tenths of 1¢ per gallon for gasoline cracked by Aetna Oil Co. The contract also contained a provision permitting Aetna Oil Co. to commute future royalty payments which would be due under the agreement by making a lump sum payment which would permit an annual production thereafter of 200,000 barrels of gasoline. Aetna Oil Co. exercised this option and entered into a supplemental agreement with Gasoline Products Company pursuant to which Aetna Oil Co. was to pay to Gasoline Products Company $120,000 in six equal installments. The Court in that case first decided that under the contract there was in "indebtedness", as that word was used in that statute, and then considered the question of whether or not the written instrument in which Aetna Oil Co. agreed to pay $120,000 in six installments was a note within the meaning of that statute. The portion of that Court's opinion in that case so clearly and concisely states the contention of the petitioner in this case that the petitioner asks the Court's indulgence in quoting it in its entirety herein:

> "The remaining requirement under the statute is that the $120,000 indebtedness be evidenced by one of the written instruments designated in the statute, issued and in existence on December 31, 1937. Plaintiff claims that the Supplemental Agreement is a 'note' within the meaning of the statute since it contains all of the elements to constitute a note in the legal sense of the term. It is agreed that it is not a negotiable note nor a negotiable instrument, but Section 27 (a) (4) of the Revenue Act does not require the instrument to be a negotiable one. The essential elements of a note appear to be the written unconditional promise to pay another a certain sum of money at a certain time, or at a time which must certainly arrive. No particular form is necessary so long as the instrument embodies these essential characteristics. 10 Corpus Juris Secundum, Bills and Notes, §7, pages 413-415; 7 American Jurisprudence, Subject Bills and Notes, Section 11 Page 795; *Equitable Trust Co. v. Taylor* 146 Appl. Div. 424, 131 N.Y.S. 475; compare Sections 3720b-1, 3720b-5, and 3720b-6, Carroll's Kentucky Statutes, 1936 Edition; Sections 356.001 356.005, 356.006, Ky. Revised Statutes, 1942 Edi-

tion. The Supplemental Agreement contained all of these essential elements. It sets out the plaintiff's express obligation to pay to the Gasoline Products Company the definite sum of $120,000 in installments coming due at definite times in the future. There is nothing further to be done by the payee in order to make the obligation a binding one. *It is true that it contains other provisions than those required to be present in order to constitute a note, but such provisions in no way destroy the existence of the essential ones above referred to.* Even in the field of negotiable promissory notes, it will be observed by reference to the sections of the Kentucky Statutes above referred to that the existence of collateral promises or obligations on the part of the maker of the note, or even additional rights conferred upon the payee by the terms of the instrument, or the failure to include other elements than those referred to above, does not prevent the instrument from being a negotiable note. *The defendant contends that the written instrument is a contract rather than a note. This is merely a use of words rather than a real distinction. The instrument is a contract, but every negotiable note and nonnegotiable note must be a contract before it can qualify as a note; it must contain the essential elements of a contract, namely, an agreement voluntarily entered into between competent parties upon legal consideration on a legal subject matter.* In order to constitute a note, the contract must also be in writing signed by the maker and call for the payment of money at a definite time rather than the delivery of goods or the performance of services. It is also distinguished from the usual type of billateral executory contract in that it is executory on one side only, with the entire consideration having been passed and executed by the party who is entitled to call for the performance. Such is the exact type of contract that exists in the present case. Defendant's contention might be well taken if we should confine ourselves exclusively to the question of terminology. The statute refers to a 'note', which in the ordinary mercantile meaning is a short written instrument containing a promise to pay a certain person a certain sum of money at a certain time in the future, without introductory paragraphs and additional collateral agreements. But the statute must be construed according to its purpose and with a consideration of the circumstances existing at the time of its enactment. The purpose of this section of the statute was to limit the credit provided to cases where the indebtedness was an actual bona fide one, resulting from actual transactions in the past as reflected by the books and records of the corporation contemporaneously made. *The use in the statute of the several words 'bond note, debenture, certificate of indebtedness, mortgage, or deed of trust' indicates that no particular type of a written instrument was required so long as the indebtedness was actually evidenced by a written instrument of some type, containing the elements of an unconditional promise to pay.* The same situation is presented here as was before the Court in *Chess & Wymond v. Glenn, Collector,* D. C. 40 F. Supp. 666, where it was pointed out that the statute under which the exemption was being claimed was not in existence at the time when the actual transaction accurred which prevented the transaction from being formulated so as to strictly comply with the terms of the statute subsequently enacted. As was pointed out in that case, the Court should not require exact compliance with the statutory pattern in every detail, but should give the statute a liberal construction so as to include such transaction as contain the necessary elements, regardless of technical form. Applying such principles to the present case, the Supplemental Agreement upon which the taxpayer relies, containing all of the essential elements of a note, is accordingly held to satisfactorily meet the requirement of the statute." (Emphasis supplied.) *Aetna Oil Co. v. Glenn, supra,* at pages 965, 966.

VI.

Conclusion.

It is therefore the contention of the petitioner that the Modification Agreements of December 28, 1950, together with the prior License Agreements which they modify, constitute "notes" both as that word is defined in general law and as it is used in Section 439-(b)(1) of the Internal Revenue Code, and that, consequently, the indebtedness of the petitioner to the several individuals named in the Modification Agreements was an outstanding indebtedness of the petitioner which it was entitled to include in its daily borrowed capital for excess profits tax purposes.

Accordingly, the decision of the Tax Court with respect to this issue is erroneous, should be reversed and the case remanded to the Tax Court for a determination of the petitioner's correct income tax liability for the years here involved.

Respectfully submitted,

WILSON B. COPES,
WELLMAN P. THAYER,
JAMES E. HARRINGTON,
Attorneys for Petitioner.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

WELLMAN P. THAYER.

APPENDIX.

Exhibits.

Exhibit	Description		Page
A	Statutory Notice of Deficiency		R. 14–23
B	License Agreement of January 1, 1944		R. 4–5
C	Modification Agrement—I. J. McCullough, O. J. McCullough		R. 5–6
D	License Agrement of October 1, 1947		R. 6–9
E	Modification Agreement—I. J. McCullough		R. 9
F	Modification Agreement—O. J. McCullough		R. 9–10
G	Modification Agreement—William G. Sweetman		R. 10
H	Modification Agreement—James M. Gray		R. 10
I	Modification Agreement—M. Manning		R. 10
J	Modification Agreement—Chester A. Marion		R. 11
1	Comparison of Cost of Patents under Modifition Agreements of December 28, 1950, to Royalties which would have been paid under the License Agreement of October 1, 1947—	Identified	Tr. 26
		Offered	Tr. 26
		Received	Tr. 36
2	Comparison of Cost of Patents under Modification Agreements of December 28, 1950, to Royalties which would have been paid under the License Agreement of January 1, 1944—	Identified	Tr. 26
		Offered	Tr. 26
		Received	Tr. 36
5	Letter to James M. Gray—	Identified	Tr. 42
		Offered	Tr. 42
		Received	Tr. 44
K	Copy of Minutes of Special Meeting of Petitioner's Board of Directors held December 28, 1950		R. 27
L	Copy of pages 90 and 91 of Petitioner's General Journal		R. 28
M	Copy of Petitioner's General Ledger Account No. 68 entitled "Liability for Purchase of Patents"		R. 28
N	Petitioner's 1951 Income Tax Return—Identified, offered and received		Tr. 48
O	Petitioner's 1952 Income Tax Return—Identified, offered and received		Tr. 48